Appeals Vol. 3352

No. 20,052

In the

United States Court of Appeals

For the Ninth Circuit

WILLIAM B. GROVER, TRUSTEE IN BANKRUPTCY OF THE ESTATE OF NORTH STATE GROCERS, INC., a corporation, Bankrupt,
Appellant,

vs.

JAMES HULL and AILEEN HULL,
Appellees.

Appellant's Reply Brief

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William B. Grover, Trustee in Bankruptcy of the Estate of North State Grocers, Inc., a corporation, Bankrupt,
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Appellees.

Appellant's Reply Brief

Appellees' Answering Brief concedes that this court, in *Wilshire Oil Company v. Costello,* (9th Cir. 1965) 348 F2d 241, has held that a Notice of Assignment of Accounts Receivable must be signed by the lender to be valid. There is no logical distinction as to a Notice of Inventory Lien and we will not argue the point further. The *Wilshire* decision is squarely in point and holds, correctly we think, that the lender's signature is necessary to the validity of both a Notice of Assignment of Accounts Receivable and of Notice of Inventory Lien.

Their second contention, that a supposed existing lien is not invalidated upon assignment of the security interest

may require answer. As applied to the facts of this case, it is both confusing and without merit.

1. Appellees' contention applies only to the proceeds from the sale of inventory; it does not apply to the proceeds of accounts receivable.

Involved in this appeal are two separate items: (a) the proceeds of accounts receivable, and (b) the proceeds of a sale of inventory on hand at the time of bankruptcy.

Under former Section 3037 of the Civil Code, a Notice of Assignment of Accounts Receivable must have been filed to maintain the priority in the proceeds of any inventory sold which was originally covered by an inventory lien, where such proceeds constitute an account.

> "§ 3037. . . . .
>
> If such proceeds are an account as defined in Chapter 3b of this title, the lenders' rights to the account or accounts as against third persons are governed by the provisions of said Chapter 3b except that the written statement provided for in Section 3031 of this title shall, unless stated therein to the contrary, constitute an assignment in writing to the lender of any account or accounts that may arise from the sale of any of the merchandise designated therein. In order to perfect his rights to such proceeds which are an account as defined in Chapter 3b of this title, as against third persons, the lender shall comply with the provisions of Chapter 3b relative to filing a notice of assignment or of intention to assign an account or accounts, and his rights to such account or accounts and the proceeds thereof shall be inferior to those of any other assignee of such account or accounts who has first filed the notice of assignment or of intention to assign an account or accounts, or a further notice or affidavit filed prior to the expiration of such notice of assignment pursuant to said Chapter 3b, regardless of whether the assignment of such ac-

> count or accounts to such other assignee is prior or subsequent to the written statement provided for in Section 3031 or the filing of the notice provided for in Section 3033, or any assignment of such account or accounts to the lender."

The only Notice of Assignment of Accounts Receivable ever filed was the defective notice filed June 19, 1962. Their claim of a prior lien is limited to the original inventory lien and, accordingly, Appellees have no claim to the proceeds of accounts receivable. At best their argument would reach only the proceeds of the inventory sold after bankruptcy.

2. There is no evidence in the record of any valid lien; in fact the evidence is that there was at best an imperfect lien at the time of the "assignment" to Appellees.

Appellees argue that they are entitled to the proceeds of the inventory sale because of the October, 1960, transaction between Farley and Audia and Redding Specialty Products, Inc., and state as a fact that there was an existing valid lien created. There is absolutely nothing in the record to substantiate this contention.

On the contrary, Appellees themselves recognized that there was a substantial question as to the validity of any "existing" lien. In the instrument of assignment dated May 31, 1962, (I Tr. pages 26 to 29) signed by Appellees, it is expressly provided:

> "7. The Lenders understand that there may be some question concerning the legality and validity of the inventory lien and the accounts receivable assignment mentioned above and it is expressly agreed herein by and between Audia and Farley and Lenders, and each of them, as follows:
>
> (a) That the transfer and assignment of such inventory lien agreement and assignment of accounts receivable and other instruments is without recourse

to Audia and Farley and that they shall not be responsible for the payment of the obligations secured thereby.

(b) That Audia and Farley make no warranties, express or implied, representations, guarantees, indemnities or promises or agreements whatever concerning the validity of such inventory lien and assignment of accounts receivable and other instruments and the Lenders agree and understand that Audia and Farley are quitclaiming their interest only in such agreements and instruments and assignments and the Lenders hereby waive any claim of any kind whatever as and against Audia and Farley by reason of the failure of Borrower to pay the moneys due from it or by reason of the invalidity, in whole or in part, for any reason of the inventory lien or the assignment of accounts receivable, or any other instruments herein transferred."

Appellant has admitted that a notice of inventory lien was recorded by Farley and Audia. Appellees, however, did not choose to introduce any other evidence of its validity or of the indebtedness secured thereby.

3. The June, 1962, transaction involved a new loan arrangement between Appellees and the bankrupt. At best it was a novation.

The document entitled "Assignment of Inventory Lien, Inventory Lien Agreement and Assignment of Accounts Payable" (I Tr. pages 26-29) signed by all parties, Farley and Audia, Appellees herein and Redding Specialty Products, and through which Appellees claim to have succeeded to Farley and Audia's rights, was not an assignment of debt with its security as Appellees in their brief seem to imply. The agreement provided first that Appellees were "substituted" "in place and stead of Audia and Farley" and the bank agreed to "accept and novate" the Appellees in

their place and stead. (I Tr. page 26. paragraph 1; page 29) Secondly, it provided that the inventory lien, the validity of which appeared to be in question, was transferred to Appellees, but it should be noted that no indebtedness was assigned. Thirdly, the agreement provided that Appellees would discharge the debt of the bankrupt to the Bank of America and secure the release of Farley and Audia from their guaranty of the bankrupt's obligation.

Nothing in the record evidences any debt except the debt to the Bank of America. This debt, we may be sure, could not be and was not transferred by Farley and Audia to Appellees. It is apparent, and the parties so acted at the time in question, that the agreement was a new agreement between Appellees and Redding Specialty Products whereby Appellees undertook to pay Redding Specialty Products' note to the Bank of America and to advance it additional funds which funds were to be secured by a newly created lien. The testimony of James Hull shows that this was in fact the consideration for the agreement, (II Tr. page 24, lines 13-21; page 32 lines 3-6). The inventory lien was thus security for the obligation under the new agreement, not the assignment of a debt from Farley and Audia because no such debt was assigned by them.

The District Court in its Memorandum and Order herein adopted the finding of fact of the Referee with respect to this agreement and characterized the agreement as follows: "This document was signed by all parties and essentially transferred Leo Audia and Ronald L. Farley out so that the agreement was now between Redding Specialty Products, Inc., and James Hull and Aileen Hull." (I Tr. page 40, lines 12-14) The label put on the agreement is not important. Legally it was a new contract between Appellees and Redding Specialty Products, a contract measured by the terms and agreements of the former inventory lien agreement,

but nevertheless a new loan and a new lien. The same effect would have been achieved had Appellees loaned the bankrupt funds to pay off the note to the Bank of America and thereupon secured the newly created debt from the bankrupt with an inventory lien. The document itself appears to add no further efficacy except to the extent that Farley and Audia were relieved of their burden of guaranty and that no new inventory lien agreement need be retyped. At best, and only when and if the Bank of America note was paid, the agreement might be characterized as a novation, that is, the substitution of one creditor for another.*

The alignment, however, of the parties, so far as it appears in the record, does not indicate Farley and Audia were actually creditors of the bankrupt, except to the extent they may have had a contingent right over against the bankrupt if obliged to pay off the Bank of America. The additional advance to the bankrupt of $30,000 made by Appellees was a new transaction. It is clear, therefore, as both the District Court and the Referee agreed (although

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*The legal effection of a novation is, of course, an extinguishment of the original obligation which does not revive regardless of a failure to perform the new agreement. *Alexander v. Angel* (1951) 37 C2d 856, 863.

A novation and its effects are defined in *Eckart v. Brown* (1939) 34 CA2d 182, 187, as follows:

> "(1) Novation is the substitution of a new obligation for an existing one and is made (a) by the substitution of a new obligation between the same parties with intent to extinguish the old obligation, (b) by the substitution of a new debtor in place of the former one with intent to release the latter, or (c) by the substitution of a new creditor in place of the former one with intent to transfer the rights of the former creditor to the new creditor. (Sec. 1531, Civ. Code; 46 Cor. Jur., (1928) 573, sec. 1.)
>
> "(2) The effect of a novation is to make the original agreement a nullity (that is, void and of no effect), and the rights of the new parties are governed solely by the new agreement. [citations] *The novation in legal contemplation gives rise to a situation which is the same as if there had never been a former agreement or obligation.*" [Emphasis added]

reaching opposite conclusions on the issue) that the issue in this case is whether or not the notices recorded by Appellees in June of 1962 sufficiently complied with the code to perfect a new inventory lien. Admittedly they did not.

4. The new loan transaction required a notice to be filed signed by the new lender because the prior notice no longer complied with the law.

It is elementary that whatever equitable rights the assignment of the inventory lien from Farley and Audia gave to Appellees, the recorded notice of the lien was not property and could not be assigned. Appellees recognized this and did in fact record the defective notice of inventory lien. They also recorded a similarly defective notice of assignment of accounts receivable which had not been recorded by Farley and Audia.

The District Court herein recognized that upon execution of the agreement in May of 1962, the notice recorded by Farley and Audia no longer complied with the law requiring the notice to be signed by "the lender." (I Tr. page 45 lines 9 to 15). While the provisions of the Civil Code do not specify precisely how and under what circumstances a new or amended notice should be filed, it is clear that where the original notice no longer complied with the law, the protection afforded by the recording laws could be achieved only by recording a new notice which did so comply and which was signed by the lender.

Appellees ignore this fact and to point to the language in Section 3034 ("Amendments of the notice may be filed") claiming that such amendments are permissive. This is a fictitious issue. The sentence in Section 3034 which refers to amendments of notices read as follows: "Amendments of the notice may be filed from time to time in the same manner to record any changes in the information contained

in the original, subsequent or amended notices." As this court pointed out in *Wilshire,* the word "may" used in a statute can actually be mandatory, as in this case it was patently so. The Farley-Audia notice no longer complied with the requirement that the notice be signed by the lender. Without a new or amended notice, there was literally and simply no notice of record which fulfilled the requirements of Section 3032. There is no greater weight to Appellees' argument that a "valid" inventory lien cannot be lost by failure to re-record upon assignment than there is to suggest the lien cannot be lost if, for example, the merchandise were changed to an address different from the one stated on the original notice. The statute obviously contemplated that in the case of such a "floating lien" that the lender's rights could and were subject to loss by circumstances which might be beyond the lender's control.

The amendment provided for in Section 3034 refers to "changes in information". This clearly means the information required to be given in the original notice—namely, the names and addresses of the lender and borrower, the maximum amount of indebtedness to be secured, the type of merchandise subject to the lien and the address at which such merchandise is located. The suggestion of permissiveness from the statutory language thus would rather indicate that the lender "may" or "might" record such amendments, but that he must do so if he wished to protect himself.

In the same connotation and with respect to the change of the name of the borrower from "Redding Specialty Products, Inc.," to "North State Grocers, Inc." the District Court, by its holding that the inventory lien would not be binding on subsequent creditors who did not know of the change of name, clearly assumed that an amendment of the notice would have to be filed to validate the lien despite the

"permissive" language of the sentence quoted above. Appellees' argument, therefore, that "amendments" are merely permissive is wrong. In any event it cannot be used to supply a deficiency, namely, that in this case the original notice upon which Appellees now rely, was not in fact signed by the actual lender. It no longer complied with Section 3032.

Both the District Court and the Referee recognized the true issue in this case, is that the statute required the signature of the lender and that there was literally and simply no recorded notice signed by the lenders who by their own testimony and documents are the Appellees. Under these circumstances it is clear that a notice signed by the lenders must be recorded to validate the lien. This Appellees did not do.

CONCLUSION

Appellees concede in effect that their rights to the accounts receivable or their proceeds must fall under the decision of this court in *Wilshire.*

As to their claim to the proceeds of the inventory sale, the evidence shows a new agreement was entered into by them and by the bankrupt for which an inventory lien was to be security. Their failure to sign a notice, as well as their subsequent failure to record a notice when the bankrupt changed its name, invalidates the claimed lien as against the trustee in bankruptcy, Appellant herein.

Appellant respectfully submits that the order of the District Court insofar as it declared Appellees' liens as valid prior to the name change should be reversed.

Dated: December 17, 1965. San Francisco, California.

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CERTIFICATE OF COUNSEL

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

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